LEASING EQUIPMENT TO PRC ENTERPRISES -

THE PRACTICAL PROBLEMS

BY

HO WING KEI
何榮基

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Dr. Andres Inn

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(Dr. Andres Inn)

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ABSTRACT

Equipment leasing has become increasingly important in the People's Republic of China as the country adopts an open-door economic policy and advances towards "Four Modernisation". In view of the leasing industry's bright prospects, more and more foreign equipment suppliers, leasing companies and financial institutions seek to engage in leasing transactions and develop the market in China.

In the report, the writer examines the current development of equipment leasing in the PRC. In addition, he also attempts to assess and analyse the problems for foreign businessmen in the transactions, and presents various suggestions to solve the problems.

Much data in this research have been gathered through conducting surveys and interviews with leasing experts and people who are involved in equipment leasing in the PRC. Apart from that, the writer has acquired much knowledge on the subject directly by helping a research firm organise a seminar "Equipment Leasing in the PRC" in 1984.

Owing to the limited amount of time and resources, the study is by no means exhaustive. However, the writer is confident that equipment leasing will play an increasingly significant role as a means of financing in China.

ACKNOWLEDGEMENTS

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CHAPTER I

INTRODUCTION

Recent Economic Development in the PRC

The People's Republic of China (PRC) has adopted an economic open-door policy since 1978 and promoted its transactions with the outside world. International exchange of techniques have been greatly strengthened as the Chinese government recognises the importance of foreign co-operations in the course of its four modernisation constructions. China thus assured significant changes in its foreign policy by suggesting that past political and economic development strategies based on self-reliance would now be supplemented by greater foreign participation and assistance. In this respect, the PRC takes both active and effective measures to bring in foreign funds and import advanced technology and equipment.

The Chinese government has permitted the establishment of joint ventures using local and foreign investments since 1980. Other forms of economic co-operation such as the processing of imported materials, compensation trade and leasing are also undertaken to provide equipment and to raise funds for Chinese enterprises.

Leasing plays an increasingly important role in China's economic co-operation with other countries by using foreign funds to import equipment. In fact, leasing is applicable in almost any equipment supply situation - from small simple items all the way through complex multi-million dollar projects.

Leasing Defined

Leasing can be defined in various ways. The following definition is adopted by the equipment leasing association in the United Kingdom. " A lease is a contract between a lessor and a lessee for the hire of a specific asset selected from a manufacturer or supplier of such assets by the lessee. The lessor retains the ownership of the asset during the term of the contract. The lessee has possession and the use of the asset on payment of specified rentals over a period."

Types of leases

Leases can be divided into two categories - operating leases and finance leases.

i Operating leases

Operating leases are generally short-term, cancellable contracts under which the lessor assumes all or most of the responsibilities of ownership. This method is more flexible for the lessee because the equipment may be leased only for short periods of time. However, rates may be comparatively higher to compensate the lessor for bearing the operating costs and the risks of obsolescence.

An operating lease offers equipment on a fully operational basis. The lessee gets his machine, and with it comes operations, training and support as well as maintenance supplies. Once the lease period expires, the lessee can either return the machine, renew the lease or upgrade to another new machine.

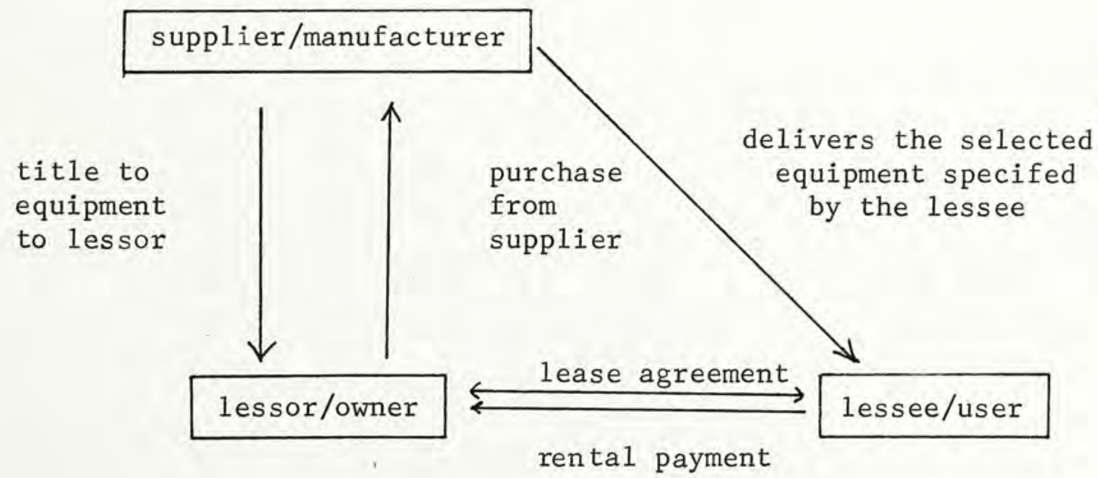
In an operating lease, the asset is not wholly amortized during the non-cancellable period, if any, of the lease, and where the lessor does not rely for this profit on the rentals in the non-cancellable period. Operating leases are usually arranged by equipment suppliers or their affiliated finance companies.

These suppliers are expected to be co-operative regarding the cancellation of an existing lease. They usually have the sales organisation to recover a satisfactory residual value.

ii Finance leases

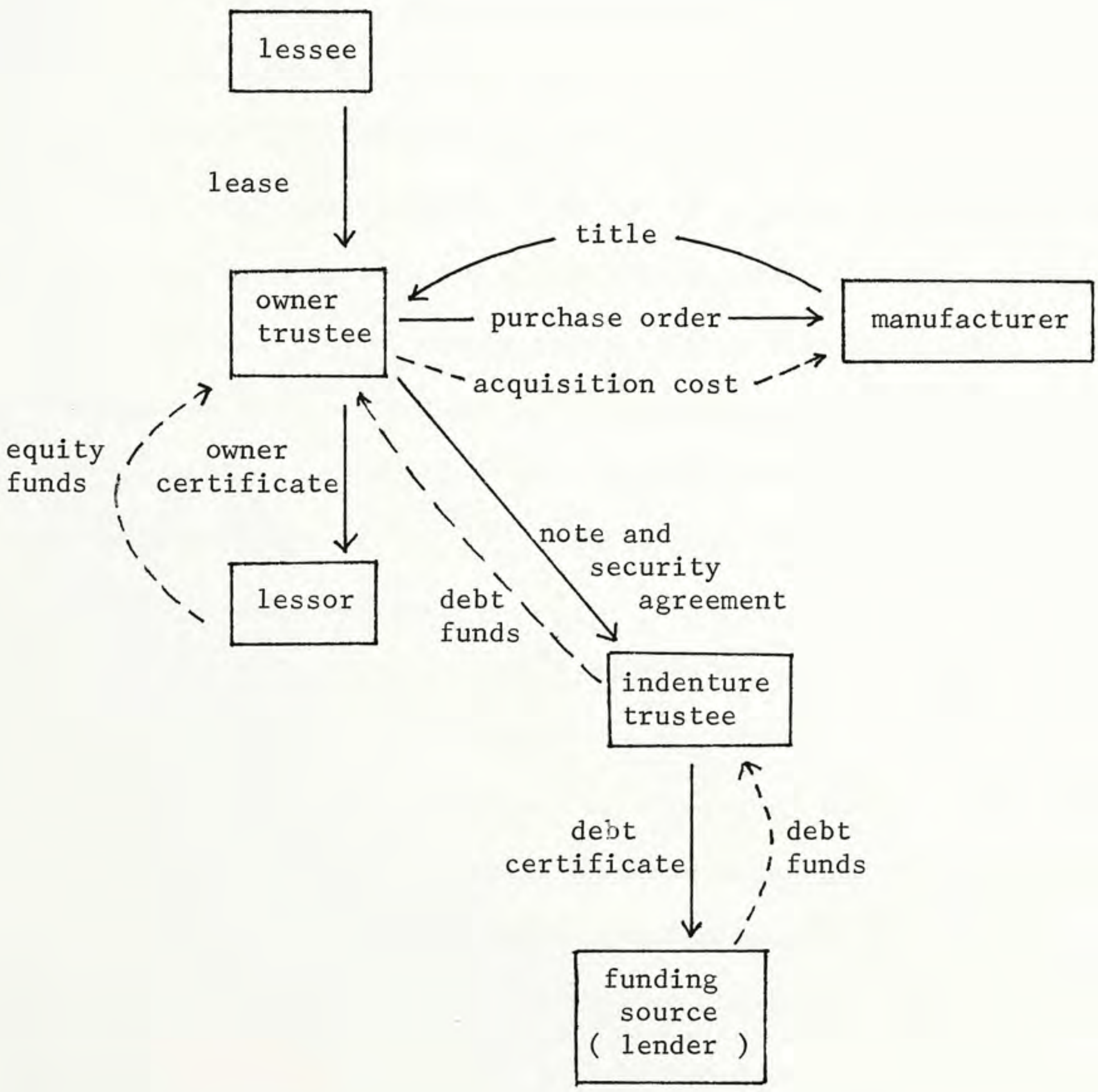
A finance lease is a contract between lessor and lessee for the hire of a specific asset selected by the lessee. The lessor retains the ownership of the asset, while the lessee has possession and use of the asset on payment of specified rentals sufficient in total over a period to amortize the capital outlay of the lessor and to provide for the lessor's cost and profit. In other words, the lease contract will usually be long term, matched to the useful life of the equipment. The lessee in effect obtains deferred payment terms for the use of the asset. On expiration, the asset may be returned, replaced, sold to the lessee or sold to a third party, often at a predesignated price.

Finance leases are typically provided by leasing companies affiliated with financial institutions. That is why the lessee takes full responsibility for insurance and taxes and enters into a separate maintenance contract with the equipment supplier which protects the lessor from any maintenance dispute.



iii Leveraged leases

Leveraged leasing is a sub-category under the general heading of finance leases. This lease structure is so complex that it is only economical for high value "big-ticket" transactions. The lessor puts up only a part of the purchase price of the equipment but takes all the benefits of ownership. The balance is financed through another lender. The benefits to the lessor, include the lease rental flow and also tax consequences of ownership.



In many developed countries, capital investment is encouraged by granting tax incentives, which include investment tax credits and accelerated depreciation. The lessor in a leveraged lease can claim 100 % of those tax allowances while putting up perhaps only 15 % of the money. The attractive return to the lessor enables him to reduce the lease rental to the lessee. The cost to an equipment user may be lower than any other means of acquiring the equipments - cheaper even than paying cash. Leveraged leasing caters for the majority of off-shore leasing transacted with Chinese entities.

Leasing in the PRC

Modern leasing has a very short history in China. The professional leasing institutions were established in the beginning of 1980s. Oriental Leasing from Japan set up a joint venture known as China Orient Leasing with two Chinese corporations - China International Trust & Investment Corporation (CITIC) and the Beijing Machinery and Electronic Equipment Corporation. From then on, the company concentrates on financing export oriented industries since that would enable repayment of loans in part foreign exchange.

China Leasing Company was a joint investment by CITIC and State Bureau of Supplies. The company commenced business in 1981 and since then have set up about 30 co-operative departments in various provinces of China. There are plans for more, especially in Guangdong province and the Shenzhen Special Economic Zone. Business relations have been established between China Leasing Company and more than 400 enterprises, financial institutions and leasing companies around the world.

Qingdao Leasing Firm was another operating in Shandong province. Other organisations engaged in leasing business are CITIC, local trust and investment firms. Most of the leasing institutions in

China deal with both finance leasing and operating leasing, although the former is more common.

In 1983, Trilease International Ltd. was incorporated in Hong Kong. It is a joint venture leasing company, of which 40 % is owned by the Bank of China and Societe Generale, with the remaining 20 % owned by the Bank of East Asia. The joint venture runs equipment leasing business in Hong Kong and China.

Goods for leasing are manufactured both in China and abroad, and leased to Chinese enterprises, institutions or foreign companies. The imported equipment through leasing varies in a vast categories including aircraft, ships, vehicles, manufacturing equipment for light industries (mainly the textile and electronics industries), medical instruments, steel mills and computers. It is expected that there will be a wider range of leasing business in China in future.

Lease Structures in PRC - Domestic vs Cross-border leases

Domestic leasing is the leasing of goods to enterprises located in the same country as the leasing company. A cross-border lease, on the other hand, involves a lessor in one country and a lessee in another. The relations may be even more complex, in which case the lessor, lessee, funding source and equipment vendor are all from different countries.

There are many ways in which international leasing transactions can be structured. In any case, a cross-border transaction presents considerably more structural complexity than a pure domestic transaction. Among items which have to be considered are the property rights of the lessor and lessee, including redelivery and repossession, customs and import duties, foreign exchange availability and currency convertibility, interest and rental taxes, profit taxes as well as profit repatriation guarantees.

At present, there is little domestic leasing going on by Chinese lessors denominated in Renminbei (RMB). Although this will gradually develop, for the time being, almost all PRC leasing involve at least one international element - either the currency, manufacturer, funding source, the lessor or the trustee.

The boom in the leasing industry

Leasing has been growing rapidly in the United States and Europe from the 1960s. The industry has prospered in the Far East since 1963 when Japan started its first leasing company, and the spectacular growth of the leasing industry has now spread to China. China Orient Leasing's business grew from US $2 million in 1981 to US $13.5 million in 1982, and rose further to US $40 million in 1983. China Leasing Company concluded deals worth US $32 million in 1983 and in 1984, the figure reached US $50 million.

CHAPTER II

METHODOLOGY

Objective of the Research

The recent boom of equipment leasing in the PRC has been covered in the previous chapter. The industry is expected to develop further in coming years. The objective of this research is to identify the various problems which leasing companies and equipment suppliers have faced, and examine the ways in which the companies have handled these problems to make leasing more attractive to users in the PRC.

Research Instruments

The information was gathered mainly through literature research, interviews, telephone surveys and organising seminar. Since leasing is a new area of equipment supply in China, most information was collected through extensive discussions with equipment suppliers, leasing firm executives, accountants and lawyers who are experts in the leasing field, they have contributed much to make this study more comprehensive and reliable. Telephone interviews are also conducted with firms actively involved in China trade to collect their views on leasing. Further data have been acquired through the organisation of a seminar on "Equipment Leasing in China" for Business Resources and Services International, which has been helpful for understanding the subject.

1. Telephone survey

In view of the low response rate anticipated with mailed questionnaires, equipment suppliers and financial institutions have been contacted by phone and interviewed for their views on leasing in the PRC, in particular the problems they encountered or anticipated. Information from the interviewees was content analysed and is summarised in this report. The findings have greatly enhanced the understanding in the China traders' attitude towards lease financing.

Some 40 equipment suppliers, who are on the telephone list published by the American Chamber of Commerce, were called up for the survey. The list contains all U.S. companies trading with the PRC. U.S. companies are chosen for the survey because they play a very important role in providing technology and equipment to China. Moreover, as statistical analysis on the data is not intended, it is not important whether the samples are a good representation of the population or not.

These U.S. companies provide a broad range of equipment, from earthmoving machines to office automation equipment. In all cases, the managers or officers in charge of the companies' China trade divisions were contacted to see whether they are leasing equipment to users in the PRC. If the answer is in the positive, they will then be asked about the type of problems they have confronted in China's leasing arena. Otherwise, the questions will turn onto the difficulties they foresee which may discourage them from going into the market.

2. In-depth personal interviews

Personal interviews have been arranged and it is the major source of information for this research. The interviewees are selected so that the legal, taxation and accounting, financial as well as the practical aspects of equipment leasing in China will all be covered.

Having narrowed down the problem areas of leasing industry in the PRC, experts in the trade were consulted on the actual difficulties and the possible solutions. The experts are from various professional sectors to cover different aspects in the leasing field.

interviewee's profile

type of company	name of company
law firm	Baker & McKenzie
accounting firms	Deloitte, Haskins & Sells
	Coopers & Lybrand
finance companies	Chemco Finance (Hong Kong) Limited
	Midland Bank
leasing companies	Trilease International Limited
	Diamond Lease (Hong Kong) Limited
	Orient Leasing (Asia) Limited
oil drilling company	Bristol Minerals Limited
others	Diary Farm Company
	ICI (China) Limited

In-depth interviews can help in forming a more detailed and accurate picture of the industry. There are no fixed set of answers, the scope of data can be flexible and the interviewees are free to express their views frankly and openly.

The findings are reported in the following two chapters. Chapter III is a general description of the leasing environment in the PRC, while Chapter IV summarises the practical problems concerning equipment leasing.

CHAPTER III

LEASING ENVIRONMENT IN THE PRC

Future Growth in the Leasing Industry

When China signed the first lease agreement for Boeing aircraft, it opened up a whole new area of equipment supply in the country. The growth of the leasing sector during the past few years has been very encouraging, and there are indications that this upward trend will continue in coming years.

The State Economic Commission leaders in Beijing predicted that between 1985 and 1987, China will invest some US $32.25 billion in new equipment for existing industries. The funds will be required to finance more than 10 000 modernisation projects in some 8 000 enterprises. It is interesting to note that 14 coastal cities in China have a better chance of concluding large contracts. For instance, Shanghai and Tianjin can approve projects up to US $3.8 million without prior approval from the central government. The limit for both Guangzhou and Dalian is US $600 000. These 14 cities offer tax concessions similar to those in the four special economic zones. It is obvious that China is seeking ways to increase foreign investments by reducing taxes and bureacratic controls on trade and industry in these regions.

Hence equipment suppliers stand very good chances of doing business with China. They can arrange direct sales or leasing. However, because of the advantages leasing enjoys over outright purchase (which will be examined in later part of this report), lease financing is expected to become more and more popular among PRC users. And it is up to the equipment suppliers to "package" the deal to make leasing more attractive.

Equipment suppliers can lease equipment direct to users. Alternatively, they may arrange the financing through a leasing company, which becomes a partner of the equipment supplier, sharing the risk together.

Equipment Leasing - tax and accounting issues[1]

One of the first problems in the treatment of leasing for accounting and tax purposes is whether the lease will be considered as an operating or a finance lease. This will greatly affect income tax, customs duties and how the transaction is reported in the financial statements.

The Chinese authorities have not put down any legislation for this issue. It is expected that they will develop in the near future criteria in determining the nature of an equipment lease. Most probably they will look to the practice of the United States to set their own policies, mainly because of the important role the United States have played and will continue to play in providing technology and equipment to China. Therefore, the United States' tax treatment of equipment leases will at least give some indications to the type of criteria which the Chinese taxing authorities may adopt.

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[1] Most of these materials are extracted from Mr. Arthur Ho's presentation at a seminar on "Equipment Leasing in China". Mr. Ho is a partner of Price Waterhouse, Hong Kong.

PRC Taxes

There are a number of charges which enterprises doing business in the PRC will be subject to.

1. income tax - net income in a year after deduction of costs, expenses and losses in that period is taxable. Interest expense on working capital is deductible while that on fixed assets is added to the capital cost of the assets.
2. consolidated industrial and commercial tax (CICT) - CICT is a transactional tax. There is a special clause imposing CICT on imports. The tax rate differs according to the type of products. It ranges from 1.5 % to 69 % of the amount paid. If the lease is treated as a sale, the tax rate applicable would in most cases be 5 % of the amount paid for the equipment, which includes such things as freight charges, customs duties and service charges. If the lease is considered a true lease, then the lease payments will be subject to CICT. In most cases, the applicable rate of tax would be about 5 % of the lease payments.
3. customs duties - most equipment imports will be subject to customs duties at a rate of 5 to 20 % of the equipment price.

How these taxes are levied depends on the investment vehicles foreign companies use in leasing equipment to China. The various options open to them are: branch office in the PRC; equity joint venture; contractual joint venture; or operation outside China. In many cases, equity joint ventures and contractual joint ventures are exempted from CICT and customs duties for goods imported into China. The implications of the tax rates applicable will affect the companies' decision of how to lease equipment to China. This issue will be discussed later in greater details.

The US tax regulations are an attempt to examine the transactions and determine whether the parties intend to complete a sale transaction or a lease transaction. If an equipment lease does not meet all the conditions of an operating lease, it will not be a true lease and will thus be treated as a sale transaction for tax purposes.

The conditions of an operating lease are:

1. At all times throughout the lease term, the lessor must maintain an "at risk" investment of at least 20 % of the cost of the property, which means that even at the end of the lease term, the residual value of the property must be at least 20 % of the original cost of the equipment.
2. In case the lessee is given the purchase option at the end of the lease, the price must be at least 10 % of the equipment's original cost.
3. The lessee may not furnish any part of the cost of the property, which means that he is not allowed to provide any part of the cost for improvements or additions to the property.
4. The lessee may not loan the lessor any funds to acquire the equipment or guarantee lessor debt in connection with equipment acquisition.
5. The lessor must show that he expects to earn a profit from the transaction exclusive of the benefits.

As the Chinese authorities have no hard and fast rules regarding the sale against lease issue, the abovementioned criteria may be used as guidelines to structure a lease transaction. However, before any legislation is firmly established, one would still have to consult with the authorities on how a particular transaction should be categorised.

China's Attitude towards Equipment Leasing

By definition, leasing constitutes use rather than ownership. The use of a piece of equipment is far more important to the generation of income than a piece of paper conveying title to the equipment. However, in the PRC, the feeling that ownership is the most important element still exists. This belief has greatly inhibited the growth of leasing. Leasing companies and equipment suppliers have to overcome the false perception common in China that not owning is a sign of weakness. The utmost important thing is not necessarily how much one owns but how well one utilizes one's ownership. Fortunately, this attitude is beginning to change gradually.

In fact, where leasing has become a way of acquiring equipment, this change of perception has occurred. This is accompanied by a shift in accounting practices in which the income statement takes on more prominence while asset levels on the balance sheet fade as a prestige factor. It is expected that lease financing will gain in prominance in China as development takes place and as users increase their awareness of the benefits of improved cashflow.

Attraction of Leasing to PRC users

Since the launching of the "Four Modernisation" programme, PRC has been trying to develop its industries and agricultural productions. The need for modern equipment becomes a very popular financing alternative.

1. A Chinese entity before buying a piece of expensive machinery from abroad has to contact overseas suppliers, obtain approval from the central government and finally arrange payment. Much red tape is involved. Equipment leasing, however, enables an enterprise to obtain the machinery immediately without arranging

for the complicated, and usually prolonged, central government approvals necessary for equipment purchase.

2. Future lease payments to which an enterprise has committed are not reported as liabilities. As a result, the balance sheet looks significantly stronger than it would if outright purchase has been made. Chinese managers have become very conscious of balance sheets since the government increasingly rewards productivity and efficiency in enterprises.
3. For a contractor, the liability reduction may also improve bonding capacity and thus improve the success ratio of bidding for construction projects. Since competition for project bidding is keener nowadays, leasing equipment becomes more important as a method of acquisition. Offshore contractors working in China surely recognise this and therefore are prime candidates for leasing.
4. PRC's foreign exchange reserves are managed carefully by the Chinese authorities. The actual amount possessed by individual corporations is small and invariably insufficient for buying equipment directly from overseas. Leasing is a way to acquire equipment without substantial downpayment so that the enterprise's existing lines of credit may remain unchanged. Equipment users may pay off the equipment with cash generated over the leasing period.

Accelerated Depreciation for Foreign Investors

Foreign investors may enjoy preferential treatment concerning depreciation of assets for faster capital recovery. The depreciation period for fixed assets can be shortened for capital recovery acceleration. The shortest possible depreciation periods, for various kinds of fixed assets of joint ventures and foreign enterprises in China, have been specified. All of them, except those for houses and buildings, which are fixed at 20 years, are set at either 5 or 10 years. If there are special reasons which require the depreciation of fixed assets to be accelerated, the depreciation period may be shortened after an application is approved by the Chinese tax authorities.

Special considerations have been given to those involved in offshore petroleum exploration and development. The exploration expenses incurred may be amortized over a period of not less than one year, and various kinds of fixed assets may be depreciated over periods of not less than six years. Also, depreciation may be calculated in accordance with a composite-life method.

CHAPTER IV

DATA INTERPRETATION AND RESULTS

Foreseen Problems for Leasing Equipment to PRC Lessees

Among the 40 equipment suppliers interviewed, only three of them are currently engaged in the leasing business with the PRC. The others are not leasing any equipment to China at the moment, but they are actively involved in China trade, mainly arranging direct sales of equipment.

The most common reason for not engaging in leasing is that leasing is regarded as a very risky business. There is little information whereby one can develop a standard credit approach for discerning creditworthiness. In fact, there are not very many international lenders that can claim to have sufficient credit experience in the PRC. And in case a lessee defaults payment, they are uncertain whether Chinese legislations would allow for repossession of assets.

Some of them express worries over the transfer of technology. Problems arise as to how a technology supplier may restrict the use of licensed technology to one or several equipment users. In other parts of the world, there are usually provisions in the lease agreement to prevent leakage of the technology to other enterprises, and to discourage the licensee from provoking early termination of the licence and thereafter continuing to use the licensed technology without payment of royalties. These equipment suppliers express doubt as to whether the same can be arranged in the PRC.

Another important factor is the confusing tax treatment on a lease. Equipment suppliers feel that only large corporations supplying equipment of which the PRC is greatly in need can bargain for favourable terms with the Chinese tax authorities. The suppliers have also anticipated problems concerning service and maintenance of equipment. The PRC covers a vast territory and equipment users may be scattered all over the country. It is quite difficult to provide efficient maintenance services without a network of repair stations in the country, which is very costly for an equipment supplier. Moreover, some PRC enterprises still prefer outright purchase to leasing. It is up to the equipment suppliers to package the leasing deal to make it more attractive to prospective users.

It is apparent that a lack of knowledge and experience about leasing in the PRC discourages these equipment suppliers from developing a market in the PRC. Some prefer to play a passive role and wait for leasing companies to take the initiative. In many instances, leasing companies may approach an equipment supplier, put up its own money to purchase the asset and structure a deal for the lessee in the PRC. A finance lease is arranged and the leasing company becomes a partner with the equipment supplier in this China transaction, sharing the risk together.

Actual Problems Encountered

In-depth interviews with experts currently involved in PRC's lease industry reveal that only few equipment suppliers are arranging operating leases with PRC users. Most suppliers prefer to share the risk with leasing companies and arrange finance leases instead. In either case, the following aspects would have to be dealt with:

1. assessing the creditworthiness of the users in the PRC
2. selecting the investment vehicle to minimise tax
3. selecting the governing laws of the lease agreement for better protection
4. eliminating the conflicts over the transfer of technology
5. making the leasing deal more attractive to prospective lessees.

Credit Analysis

Leasing is in fact a form of lending. A firm leasing equipment to the PRC must first estimate the likelihood of recovering its original investment plus a profit over a specified period of time. Thus, they must ultimately be concerned with the repayment of funds loaned and this is the job of credit analysts.

The focus of a leasing company is a long-range forecast of the lessee's chances for success. In a practical sense, the credit analyst is attempting to predict the future success of the firm and its ability to repay the long term lease which is being negotiated.

In other parts of the world, credit information is more readily available. Credit analysts draw up conclusions based on the following information provided by the prospective lessee: history of the company; nature of the company's operation; management experience; financial conditions; collateral analysis; borrowing record; customers and competitors; industry conditions and governmental influences.

However, with respect to the PRC, information and experience regarding creditworthiness is extremely limited and there has yet to be developed a standard credit approach for analysing potential borrowers or lessees. Due to the differences in accounting practices between the PRC and other countries, financial statements and ratio analysis cannot be realistically used in the conventional sense to discern creditworthiness of Chinese entities as compared to standard credit analysis procedures employed by advanced economies. A lessor must be prepared to make decisions on less familiar factors and take higher risks. In view of the PRC's changing business environment and related laws, it is expected that lending practices will be developed rapidly in the near future. In the mean time, a lessor who cannot discern creditworthiness of a prospective lessee may protect himself through the following practices:

1. Obtaining a guarantee:

   A lessor can derive a great deal of comfort by having transactions guaranteed by a Chinese guarantor. Risk is very much reduced, particularly when the guarantor is a government body or a state-owned enterprise. In view of the special situation in China, a guarantor must be carefully assessed to define its functional capacity, its organisational limitation, and possible change of responsibility in light of possible system reforms in future.

   With the implementation of the financial self-reliance policy, even state-owned units are no longer fully backed by the government finance. Therefore, every Chinese enterprise is now running in a limiting and self-generating financial resource environment. These enterprises may also close down if they face severe difficulties. This is most obvious for newly established corporations and enterprises, where the organisation structure, management, and financial performance are usually unstable. Credit risk is not much reduced in case these new enterprises act as financial guarantors.

   A foreign lessor may select related and financially reliable Chinese enterprises as guarantor based on their position to generate financial income and in particular foreign currency funds. Major financial institutions such as the Bank of China and provincial or municipal investment and trust corporations should receive the best credit rating. Unfortunately, it has become increasingly difficult to obtain direct guarantees from the Bank of China. In future, these guarantees will be limited to major project loans. Smaller projects, conventional lending and leasing will then be determined on a pure credit basis.

2. Relying on collateral value:

A lessor may rely solely on the leased equipment's collateral value to protect himself when he cannot obtain a Bank of China guarantee or other sovereign guarantee. In case the collateral value becomes the lessor's only fall back position in a credit, he should seek extra protection via these means:

a) lease equipment or assets that are retrievable. In other words, equipment that can be readily repossessed, repackaged or even re-exported.

b) avoid leasing specialized equipment. For lessors, the risk is greatly reduced if the equipment is demanded by a great number of enterprises. Thus, if a particular lessee defaults payment on lease rentals, the lessor may repossess the asset and arrange another lease with other users.

c) enhance the lessor's collateral position by financing less than the cost of the equipment. It is quite common that a leasing company finances only 85 to 90 percent of the asset cost.

d) arrange a repayment schedule in such a way that the lease term is shorter than the useful life of the equipment. This gives a higher residual value upon the re-sale of equipment repossessed.

e) lease equipment that is re-sellable in a secondary market. Of course, the best assets to lease are those that can be readily re-sold in the PRC.

3. Identifying lessee's legal status:

An important thing a credit analyst should determine is the legal status of a prospective lessee, which will directly affect the ultimate liability of the lessee if the lease contract is not honoured.

The PRC is a socialist state in which a particular entity actually belongs to the state, or else the entity may be organised like a private enterprise and one cannot look beyond its assets to satisfy a debt obligation. Therefore, to scrutinize the statutes, documents describing the organisation structure is an important part of credit analysis. Leasing to enterprises which is backed by the government finance will be less risky for the foreign investor.

4. Assessing the lessee's exchange availability:

As RMB is not a convertible currency, it cannot be used to purchase equipment to be imported into the PRC. A leasing company usually will have to use a third country currency. In order to avoid foreign exchange risk, the leasing company needs to be paid in the foreign currency. Right now, factories and localities are allowed to keep a portion of foreign currency export earnings for paying the lease rentals. But the lessor must be sure the prospective lessee is permitted either to retain or purchase foreign exchange. As a lease is typically a long-term contract, the lessor needs to assess the lessee with regard to foreign exchange availability throughout the lease period.

5. Leasing to selected industrial sectors:

The current economic reform in the PRC suggests a move towards capitalism. Therefore, there will be greater development in the private sectors. With this development, industrial and commercial enterprises are expected to stand on their own without the benefit of sovereign guarantee. Those who are interested in developing a leasing business in the PRC should select industries which promise or exhibit the best growth potential. Some of these industries have been designated as priority sectors for development and there will certainly be government support in the form of customs duty waivers, sovereign guarantees to obtain foreign funds, and availability of funds from the government.

Tax Planning

Foreigners leasing equipments to China find it necessary to analyse the tax implications of each transaction and to devise tax planning. The various regulations, investment vehicles utilized and the structuring of the lease agreement, can have significant effects on the economics of a lease in the PRC.

The investment vehicles used would also affect the tax burden on a foreigner wishing to lease equipment to enterprises in China. In general, the following options are open to them:

1. to operate completely outside China;
2. to open up a branch office in the PRC;
3. to become a party to an equity joint venture; and
4. to become a party to a contractual joint venture.

Operations Completely Outside China

A foreign company without an establishment in China which receives rental income and interest income pursuant to a lease will be subject to a 20 percent withholding tax on the gross amount of their receipts. This high level of withholding tax has discouraged lessors in the past.

In 1983, the Chinese government put up new regulations to reduce the withholding tax on lease rental income to ten percent for certain transactions. However, the scope of the reduction was limited. The ten percent cut applies only to lease-sales and not to ordinary rental transactions. Therefore, only those leases under which the Chinese lessees eventually gain possession of the equipment involved can benefit from the tax reduction regulation. In any case, if withholding tax is payable, there is usually no CICT.

Under these circumstances, a foreign investor has to pay tax in his place of residence. For instance, the United States taxes the worldwide income of a resident corporation. The maximum marginal rate would be 46 percent with most foreign taxes being creditable.

Setting Up Branch Offices in China

A foreign company setting up a branch office in the PRC will have its income taxable under China's Foreign Enterprise Income Tax Law (FEITL). The FEITL's progressive rates range from 30 to 50 percent of taxable income. The 30 percent tax rate applies to companies with yearly taxable income not exceeding RMB ¥ 250 000. The maximum rate of 50 percent applies to yearly taxable income exceeding RMB ¥1 000 000.

The foreign company may apply for reduction of income tax if plans to operate for ten years or longer in a trade with a low profit rate. The enterprise will be exempted from income tax in its first profit-making year and be granted a 50 percent reduction in the second and third profit-making years. The Ministry of Finance may approve a

15 to 30 percent reduction in income tax for another ten years.

Becoming a Party to a Contractual Joint Venture

A contractual joint venture (CJV) is only a contractual co-operation between a Chinese and a foreign participant, where no separate entity is formed. According to the contract terms of a CJV, each participant would contribute its assets to be utilized in the business of the venture. Therefore, each party is legally liable up to the total amount of its assets and is liable to pay its own PRC taxes.

The tax treatment on the foreign investor's income will be the same as those running a branch operation in the PRC. However, in some cases, CJVs are exempted from CICT and customs duties on imported machinery and equipment whereas a foreign branch operation does not enjoy such privilege. These exemptions are granted to specific fields such as petroleum exploration, construction and scientific research.

Becoming a Party to an Equity Joint Venture

An equity joint venture (EJV) is an investment vehicle usually chosen for the parties to limit their respective liabilities. It is a legal entity registered in China. The profit of an EJV is distributed in accordance with the equity ratio, and the same applies to the allocation of losses. Foreign investors would seriously consider forming an EJV leasing company with a Chinese party as an EJV offers big tax advantages.

The basic tax rate is 30 percent of taxable income plus a local surtax of three percent. This gives an effective tax rate of 33 percent of taxable income. In case the foreign party repatriates its share of profits, a withholding tax of ten percent will be levied on the amount remitted.

However, a newly established EJV scheduled to operate for more than ten years could be exempted from income tax in its first two profit-making years and be allowed a 50 percent reduction in the third, fourth and fifth profit-making years. Therefore, for the first five profit-making years, the average tax rate is only ten percent per year. Even if a foreign investor repatriates the funds out of China, and the additional ten percent withholding tax is levied, the total rate of effective tax will only be 20 percent. If a foreign participant reinvests its share of profits in the EJV for at least five years, it may be refunded 40 percent of the income tax already paid. And under special circumstances, the three percent local surtax could be reduced or exempted upon application. An EJV also enjoys more liberal exemptions from CICT and customs. Full exemption from CICT and customs will be granted where the machinery is part of the venture's total investment.

Choice of Investment Vehicle

Before making a decision on how it will lease equipment to users in China, a foreign company has to take into consideration the following elements:

1. tax rate applicable;
2. withholding tax rate;
3. Chinese laws for each type of investment vehicle;
4. taxing regulations of the investor's own country; and
5. certain tax treaties applicable.

The best thing for a foreign investor to do is to discuss with the prospective Chinese lessee and see what their needs are. In view of the attractive tax holiday that equity joint ventures are eligible for, EJV is likely to be the best option.

Whatever the tax laws state, they also make provisions for waivers. Past experiences show that an equity joint venture has a much stronger case for obtaining waivers and a much greater chance than other forms of ventures. Once a decision is made on the way one goes into China with a lease, there are two things a foreign investor should take note of. First, he should be sure that he is fully aware of every possible tax exemption available. Frequent consultation with lawyers and tax experts is a must. Second, if there is a Chinese partner, the foreign investor should try to achieve the maximum exemptions at the earliest possible time through the local partner.

Choice on Governing Law - Lessee's Own Protection[2]

Chinese legislation which applies specifically to the leasing of equipment is the National Economic Contract Law (NECL). The law has come into effect since July, 1982. In fact, the NECL applies to all economic contracts, which include lease agreements. Article 23 of NECL spells out the required provisions for "contracts for leasing properties" and other obligations that should be incorporated within a Chinese lease. The responsibilities of the lessor and the lessee are defined in Article 44.

As stated in Article 2 of the law, economic contracts governed

[2] Extracted from Mr. Donald T. MacNaughton's speech at the seminar "Equipment Leasing in China". Mr. MacNaughton is an American Counsellor-at-Law, Hong Kong.

by the NECL are those "agreements reached by legal persons to define their mutual obligations". The statute does not give a clear definition of a "legal person". However, the statute applies only to agreements "by legal persons" (plural), so it will govern only those contracts in which both parties involved are "legal persons recognised by the PRC". Leases that seem to fall under the category governed by the NECL include the following "internal" leasing relationships:

1. a lease between PRC lessor and PRC lessee - for example, a China trader sells equipment to a Chinese leasing company which leases in China to a PRC lessee.
2. a lease between PRC joint venture in transaction with another PRC "legal person" - for example, a China trader sells equipment to a Chinese leasing company which leases in China to a PRC joint venture lessee.
3. a lease between foreign-owned PRC enterprise and another PRC entity - for example, a lease agreement between a PRC enterprise fully-owned by foreign investors and a PRC lessee.

Exceptions to NECL

Even in an "internal" lease, foreign trade regulations may govern instead of NECL if the leased equipment is imported. For instance, if the asset is there in China for use as a result of a cross-border international trade transaction, the lessor and the lessee may choose foreign trade regulations as governing law.

Alternatively, in case the contracting parties include a foreign entity not recognised by the PRC as a "legal person", the transaction is not a purely "internal" Chinese relationship because the lease agreement is not between two "legal persons". Thus, when we examine a cross-border lease between a foreign party and a PRC enterprise, foreign trade regulations rather than NECL will govern.

Governing Law - Lessor's Preference

The lessor may best protect himself from legal risks by preparing a thorough, clear and carefully drafted lease agreement. A major problem, however, appears because existing NECL provisions directly applicable to leasing are somewhat obscure. Most people in the leasing industry also express doubts over the enforceability of fundamental lease clauses. These clauses include disclaimers of warranties, rights to remedy defaults by termination, acceleration and repossession.

Very often, lessors prefer some countries' common laws which have well-accepted and familiar provisions to Chinese laws. To cite an example, the agreement on Boeings rental to CAAC have adopted the standard international financing format. It called for the application of the law of New York. In such big equipment leasing deals, the foreign party usually has sufficient bargaining power to ask for more favourable terms.

In general, a prospective equipment supplier is likely to encounter very strong pressure from the PRC party to designate Chinese law as the law governing the lease agreement. This is most obvious in small value transactions, for example, a deal on industrial tools. In case a supplier's leverage is not as substantial as it is in a jumbo international aircraft financing transaction, the prospective equipment supplier may be compelled to agree to the use of PRC law as governing law even in a cross-border transaction.

Under such circumstances, the equipment supplier may negotiate a choice of governing law by presenting either one of the following arguments.

1. in case the foreign lessor is a "legal person" in the statute,

Chinese law must govern. This point is stated in the constitution and is not negotiable. However, by involving a non-PRC lessor in the deal, one has strong argument to avoid the mandatory scope of the NECL.

2. for imported equipment, a lessor may negotiate clause to the effect that since equipment leased is imported, NECL does not apply.

In view of an increasing desire of Chinese parties to use their own law, the lessor, in order to secure a business, may have no alternative but to agree to the application. In this case, the lessor should try to obtain a Bank of China guarantee of all obligations of the lessee.

Once a contract is approved by the Chinese authorities, it is legally binding upon both parties. The contract rather than the NECL will be the lessor's umbrella. It is perhaps helpful to include a clause as follows in the contract:

" It is understood and agreed that the equipment leased under this agreement is being imported to the PRC from abroad, that this lease agreement is therefore an economic contract for international trade as referred to in Article 55 of the National Economic Contract Law of the PRC, and that accordingly this lease agreement shall not be interpreted in accordance with the provisions for domestic economic contracts under such law. The parties further agree that insofar as the regulations in the signing of economic contracts for international trade have not yet been promulgated as of the signing of this agreement, the provisions of this lease agreement shall be enforced strictly according to their terms and that in the absence of relevant contract terms, the issue shall be resolved according to the principles of international law."

An ancillary issue that should be looked into is whether disputes should be resolved through arbitration or in court. If arbitration is preferred, it will be essential to pay close attention in drafting the arbitration agreement. If litigation is the desired alternative, it will be significant to give consideration to the choice of law and forum issues. In addition, special arrangements may be needed to assure that the chosen forum will in fact obtain the necessary jurisdiction to hear the parties' disputes.

Training for Use and Technology Transfer

PRC enterprises in general regard leasing as a form of installment purchase of equipment from foreign sellers. Since direct equipment purchase contracts usually involve the transfer to the buyers of all technology and know-how necessary to operate such equipment, PRC lessees would expect technology transfers to be included as part of the leasing deal. Very frequently, Chinese leases are conditioned on a commitment by the foreign lessor or supplier to transfer or license technology and provide relevant technical training for assembly and use of the equipment leased. The lessees in PRC generally prefer to have all terms and conditions of anytechnology transfer to be included in the terms of the lease agreements. The lessor, for example, a leasing company, enters a licence agreement with the provider of technology, know-how and technical training and in turn sublicense this to the lessee. This involves a three-party arrangement.

Alternatively, provider of technology, know-how and training may enter into a separate contract with the PRC lessee on technology licence and training agreement. In either case, conflicts would exist between the licensor and the licensee, and if these conflicts are not resolved, it will adversely affect a lease arrangement. Conflicts usually appear in the following areas[3]:

1. Scope of licence

While the Chinese licensees desire the broadest transfer of technology and the most extensive training commitment, the licensors generally want to limit the transfer of technology to that necessary to run the equipment leased only. The licensor will also insist on limiting the training to a fixed number of man-hours, beyond which an extra technical consultant fee will be levied. In most cases, they will conduct a trial run to demonstrate the way to use a particular piece of equipment. The licensor is rarely willing to guarantee the technology transferred and its application in the hands of the licensee because it has very little or no control over the competence of the workmen or engineers employed by the licensee or their application of the technology.

However, the PRC users often request that training be extended until they can operate the machine themselves. This could mean hours of repeated instructions and demonstrations. Depending on the type of equipment leased, competition for business is usually keen. Very often, the lessor has to provide technology and training at a low price, far below international rates.

In addition, the licensor usually puts a restriction on the export of goods manufactured with the licensed technology. This restriction is introduced merely to protect the licensor's own market. A compromise is usually reached by permitting exports

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[3] Part of these materials are extracted from Mr. Norman P. Givant's speech at the seminar "Equipment Leasing in China". Mr. Givant is an American Attorney-at-Law, Hong Kong and Beijing.

only to very few third world countries such as Cuba, North Korea and Yemen.

2. Duration of licence

With respect to the duration of the licensee's rights to use technology granted, a licensor usually want a long term of over ten years, during which royalties are levied. Upon the termination of the licence agreement, the use of technology will be restricted. These restrictions are usually resisted by the Chinese licensee, who generally prefer a licence term of at most seven years, after which they may use the technology without paying royalties. Again, whether the contract duration will be in the licensee's favour or that of the licensor depends on the competitive environment of the type of equipment. The lessor has to be flexible in arranging such licensing contracts.

3. Transfer of Documents

China is very eager to upgrade and modernize its existing enterprises through the transfer of modern western technology and know-how to Chinese plants. The Chinese licensee generally wants the full set of documentation related to every aspect of the equipment leased and the technology transferred. It will also want to defer payments due for technical documentation until all such documents are in its hands, and insist on a penalty for any delay in delivery of such documentation.

The licensor will limit its obligation to transfer information that is necessary and sufficient to operate the equipment utilizing the licensed technology. It will insist on receiving partial payment for the technical documentation upfront with the balance due in stages on the transfer of the remaining documents.

The usual compromise reached on this point is to require an upfront payment from the licensee against a bank guarantee provided by the licensor in the amount of the maximum penalty for delays in delivering the documents. The guarantee is then released when receipt of all documentation is acknowledged in writing by the licensee.

4. Confidentiality

Condifentiality provisions is an important part of a technology licence because they restrict the disclosure of information licensed. A licensor usually insists on the stipulation of certain provisions in the licence which limit the use of the technology to one or more enumerated factories. The provisions will state that access to the technology will be restricted to employees who operate the equipment. Employees given access to the information will have to execute a written agreement of secrecy and non-use, and those employees will not be transferred to other plants. The licence will also govern on the obligation of confidentiality to survive any expiration or early termination of the licence, and declare that the right to use the technology will cease on the expiration or early termination of the licence.

On the other hand, Chinese licensees are often willing to make verbal commitments regarding non-disclosure of proprietary information, but are reluctant to commit such undertakings to writing. China's new patent law which came into effect in April, 1985, will help to protect the inventions or utility models. However, there are important restrictions on the filing of patent applications in the PRC. Applications for inventions and utility models must be filed in China within one year of the date the applicant first filed for the protection of such inventions or utility models in another jurisdiction. Thus while new inventions can be protected, the vast majority of existing patents registered outside the PRC are not eligible for filing in China.

The law also states that food and pharmaceuticals as well as the rules and methods of intellectual activity (computer software falls under this category) will not be granted protection in China. Therefore, it is most important to include carefully drafted confidentiality provisions in agreements for the transfer of equipment and technology, to protect patents and know-how.

Cross-border leases for advanced technological items may require the contracting parties to deal with their respective export control law. For example, if the lessor and licensor are U.S. corporations and the equipment leased or technology to be transferred are included on the U.S. Commerce Department's Commodity Control List, export licences must be obtained to ship such equipment and transfer such technology to an entity in the PRC. Sophisticated computer equipment may not be exported from the United States without explicit government approval. Where the necessary export licences require substantial lead time to obtain, this lead time must be anticipated in advance by the parties.

Making the Leasing Deal Attractive to Prospective Users

To run a successful leasing business in the PRC, a foreign investor must investigate the client's needs. Lengthy discussions on the required machine models, applications, usage, maintenance services and payment schedules may help the prospective equipment user decide whether a sale or a lease would be the better deal. Very often, the final decision to lease may be based solely on financial considerations although some equipment users may put much emphasis on the machines' quality and the standard of maintenance services.

One major characteristic of the PRC's leasing industry is the lack of standard packages - particularly in the leasing of big-ticket items. A leasing company has to devise the most appropriate structure to meet specific requirements.

Finance or Operation Lease

Finance lease is of particular use in project type arrangements where the equipment requirement is a part of a large package, and where operational ability comes as a part of the whole project. In industries of manufacturing, construction and transportation where operation is more easily and readily understood, finance lease is most suitable. But when a user may not easily understand how to run a machine, an operating lease would be more appropriate. As an example, a transportation company would settle for finance leases for acquiring goods vans. But for the xerox machine in his office, he would prefer an operating lease.

Finance leases are more common in the PRC market. To make a finance lease more attractive, many leasing companies offer vendor programmes. By that, a leasing company works with an equipment supplier to offer tailored finance leases as sales tools for the vendor. As shown by discussions in previous chapters, this has proved to be a very powerful selling tool because PRC enterprises generally face the problem of foreign exchange availability. The vendor programme is simply a set of formalized agreements. The lessee has to enter into a standard form of agreement only for a leasing scheme. This programme often includes a service and maintenance contract from the equipment supplier offering a complete package to the user. The vendor programme is very popular among PRC users because of the simple documentation involved.

Payment Schedule

Equipment leasing enables a PRC lessee to maximise business opportunities by reducing assets and preserving liquidity. With a lease, enterprises with insufficient funds to buy equipment directly would be able to pay for the asset through cash generated from its use. The usual practice is to arrange 12 monthly payments annually.

However, a lessee may not always be in a position to pay the same lease rental month after month. It is thus very important that a lessor design a payment schedule which is tailored to meet lessee's changing cash flow requirements. If there is seasonality in the lessee's business, the use of quarterly or semiannual payments should be considered. In case cash is tight in the start up period, a lessor may consider skipping payments in the first few years. If the equipment user has sufficient cash on hand, arranging initial downpayment will lower subsequent lease rate. This can either be a deposit on the equipment, a rental in advance or as a leasing fee. But a lump sum at the beginning would reduce the benefit of less initial cash outlay gained by leasing instead of buying.

Another consideration is the lease 's interest rate which can be variable or fixed. A fixed rate is more suitable in a project where income is known with certainty through perhaps long term sales contracts. It enables the lessee to predict income accurately. On the other hand, a variable rate could prove to be cheaper if revenues will rise in pace with cost increases.

Options Open to Lessee at Expiration of the Lease

Upon expiration of the lease, there can be a number of options open to the lessee. A nominal purchase option enables the lessee to acquire the equipment at a bargain price. In other cases, the purchase can be arranged at fair market value or at some price between nominal and market level. Or else the lessee may choose to return the equipment, if a re-lease is not arranged. Each of these options can be adopted to suit each particular situation.

Service and Maintenance

Most Chinese users are interested in getting the best value out of a lease. For a leasing company to supply this value, it must start with the best built-in quality and most comprehensive field support. The concept of maintenance is growing in China because good maintenance can increase residual value and lower lease payments. Most customers are capable of routine service and some can even repair major items. However, others wish the lessor would assume all these responsibilities.

Qualified service support is paramount for equipment suppliers to arrange operating leases in China successfully. A leasing company, in a finance lease, must contract with an authorised service facility of the supplier to provide this back-up. In any case, the performance of the equipment reflects on the company. To set up more service centres in major cities of the PRC is an approach to satisfy the increasing number of equipment users. Also the availability of parts is critical. And the parts stock must be adequately supported by technical expertise. Suppliers entering the Chinese leasing market should plan to have people available to service the equipment. These measures are all very expensive but a foreign investor must be committed in the long run to succeed in China. A good name is a significant element for successful penetration into the PRC market. It is thus essential to provide customers with modern repair methods and adequate parts support so that downtime is minimized.

Lessor - a Bridge to the Outside World

Some prospective lessees in the PRC are quite ignorant about the range of equipment they need. Generally, it is up to the leasing companies to introduce different types of models to these enterprises. All leasing companies interviewed keep a large collection of equipment catalogues so that equipment users may know more about the models available. Hence, leasing companies play a very important role as information sources on advanced technological equipment. In some cases, they even help lessees to develop international trading links with the outside world.

CHAPTER V

CONCLUSION

Leasing in the PRC

China has been trying to raise its industrial and agricultural productions ever since it adopted the open-door policy. However, many enterprises are still unable to raise enough funds to buy equipment directly from foreign suppliers because they do not have sufficient foreign exchange reserves without prior approval from the central authorities.

Under the circumstances, leasing becomes the most convenient way of obtaining equipment. Lessees do not have to pay a lump sum for the downpayment, and they can cover the rental costs by the profits generated from the leased equipment.

Another advantage of leasing equipment is that it can simplify the procedures for absorbing foreign technology. Direct purchase of equipment from foreign suppliers by arranging loans does not only require complicated assessment procedures, it is often rejected by the central authorities.

On the contrary, when equipment is obtained through leasing, the leasing company will contact the foreign suppliers, liaise with the PRC lessee, reach an agreement and arrange rental payment. In some cases, they can make use of export credits, and the equipment can then be delivered to the related unit.

For low value equipment commonly demanded by a number of PRC enterprises, a single company in the country may arrange one transaction with the leasing company. Subsequently, this PRC company will in turn rent the equipment to the various units.

For big-ticket items such as aircraft, the lessees can choose to have leveraged leases. The leasing company, as a foreign investor, will be granted accelerated depreciation for the equipment acquired. Besides, it can benefit from various tax exemptions. Hence the lessees would often enjoy lower rents.

Prospects of the Leasing Business

Following the opening of 14 coastal cities in China, leasing companies believe that there will be a bright outlook for the future of industries and tourism in China. In recent years, China has become greatly interested in setting up joint ventures with foreign leasing companies. This will not only expand business for China, the country can acquire the partners' technology through a joint venture. Thus, this kind of leasing companies is very popular in China.

Most of the existing leasing transactions are in light industries such as textiles and electronics, but China will promote leasing business to the manufacture of machinery, chemical industry and metallurgical industry because China's equipment for these industries are still rather primitive.

Increasing Demands for Leasing

The need for leasing is acute in the PRC market. More and more leasing companies are formed to run this business. For instance, Banque Nationale de Paris has recently signed an agreement with China National Non-ferrous Metals Industry Corporation, the US First Interstate Bank and the Bank of China to establish a leasing company in Beijing. Besides, another joint venture leasing company is set up in Shenzhen. The partners in the venture are the Bank of China, Banque Nationale de Paris (BNP), Hokkaido Takushoku Bank, Bank of Communications, China Merchants Steam Navigation Co. Ltd. and Nanhai Oil Shumchun Development and Services Corporation.

One of the characteristics of running leasing business in China is that the Chinese units would usually expect leasing companies to provide the complete set of services, that is, the inclusion of consultation as well as maintenance. Therefore, leasing companies which can provide such services should have better developments.

Nevertheless, there are still many problems to tackle with developing leasing business in China. As Chinese users still lack thorough knowledge on the western leasing method, they often cannot decide which type of lease to choose. Moreover, Chinese users do not appreciate that profit can be generated from the use of equipment and not necessarily from the ownership of equipment, as they commonly believe.

A leasing company also confronts the difficulty of assessing a PRC enterprise's creditworthiness due to a lack of information and experience. A lessor must protect himself by obtaining a guarantee from another Chinese enterprise.

Leasing companies are playing an important role in introducing technology and equipment to China. Productivity of the PRC enterprises is expected to increase with the use of modern equipment. It is up to the two parties to draft special provisions in agreements to avoid subsequent disputes over the transfer of technology and know-how.

In addition, Chinese users often think they can get a more favourable lending interest rate, thus it usually takes some lengthy negotiations to reach an agreement on the interest rates. However, with a good tax planning scheme, a leasing company could maximise its tax exemptions so as to arrange the deal at a low lease rate.

Good Profit from the Chinese Market

Another important point is that China has slightly different regulations governing leasing because it generally regards leasing as a form of payment for the purchase of equipment. Fortunately, China has also observed the clauses of contracts so far. It respects the ownership of property and has assigned many arbitrators to handle leasing disputes.

On the whole, leasing has aroused general interest in China. With the development of various major industries, and the South Sea oilfield exploration, it is believed that China will purchase further expensive equipment through leasing. Therefore, leasing companies should be able to reap considerable profit once they have opened the market in China.

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